PRIME MINISTER

THE MARKETS

I attach today's evening report.

It reveals that there has been significant further intervention this afternoon, some of it in London. The total covering last night and today is put in the report at $646m. But I gather intervention has been continuing, to the tune of at least another $50m. It remains to be seen how much more is done in New York before the markets close there.

So the total of intervention is now building up significantly from the figure we discussed earlier this afternoon. I will let you know in the morning the latest position, and you will want to consider then whether to arrange a chat with the Chancellor at lunch-time, or whether to leave it until after the weekend.

Meantime you might like to have a summary of the options as I see them.

i) Do nothing. The Chancellor will I am sure continue to authorise intervention without limit. If the market quietens down all well and good. But if anything like the last 24 hours experiences are repeated we could soon be into really big money.

ii) Reduce interest rates. Timing considerations vis-à-vis the Budget apart, this is surely the wrong response. It might well help with the exchange rate problem, but is the wrong signal for the general stance of monetary policy.

iii) Consider tightening the planned stance of the Budget. This does nothing for the immediate problem, and at this stage would present major logistical difficulties. But you might want to hold this possibility in reserve for when you discuss the Budget with the Chancellor next week. It would make it easier to reduce interest rates after the Budget.

iv) Let the rate go through DM3. The Chancellor would, as we discussed earlier, fiercely resist this (although I think there are others in the Treasury who would be content). Aside from the Chancellor's attachment to stability for its own sake, the main counter argument is that a higher exchange rate is the wrong direction given the emerging balance of payments position. But the key question is how far the rate would go once the market realised that the "cap" had been removed. My hunch is that it would not rise very far, and could well be reversed quite soon. One possibility might be to urge on the Chancellor letting the rate go but agreeing that the position should be reconsidered if, say, it went as high as DM3.05. Brian Griffiths agrees with this approach.

RRCG.

Paul Gray

3 March 1988

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